

The business model of The British Virgin Islands and Panama

Armando Jose Garcia Pires



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THE BUSINESS MODEL OF THE BRITISH VIRGIN ISLANDS AND PANAMA

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Abstract:

In this note, we describe the history and the main characteristics of the tax havens The British Virgin Islands (BVI) and Panama. We discuss the financial channels used in these jurisdictions to move money and assets across borders, such as the incorporation of corporations (known as International Business Corporations), trusts that are financial holding companies, asset management companies, and captive insurers. We also analyze what steps these jurisdictions have been taking to increase the transparency in international capital transactions, to fight tax evasion and tax fraud, and to cooperate with tax authorities in foreign countries.

1. INTRODUCTION

There is no agreement on the definition of tax havens. For our purpose, we describe as tax havens, countries, states or territories where the following are observed: (1) low or nil taxation; (2) secrecy provisions for the exchange of tax information with foreign tax authorities and (3) easy and flexible incorporation (such as for example no requirement for local presence). Some of the secrecy provisions include: (1) banking secrecy law; (2) entities whose ownership and purpose are difficult to identify (such as trusts and foundations); (3) absence or intentional negligence of supervision.

In this note, we describe some of the characteristics of the tax havens The British Virgin Islands (BVI) and Panama. We start with the BVI and then pass on to Panama.

2. British Virgin Islands (BVI)

BVI are a British overseas territory with a population of 25,000 inhabitants. In spite of the small size, they host over 800,000 offshore companies¹. Financial services represent 36% of

¹ An offshore company is a company where the legal space is decoupled from the real space where the firm is located. Offshore companies are usually used to avoid some kind of legislation (tax, financial or regulatory).

BVI's GDP (£206 million). In terms of employment, however, it just represents 13% of the total employment. Notably, the BVI's financial sector employs about 2,100 people in financial services.

The main area of specialization of the BVI is the incorporation of corporations (known as International Business Corporations), trusts that are financial holding companies, asset management companies, captive insurers, and the like².

The International Business Corporations (IBCs) are limited liability companies that are set up either as subsidiaries of onshore companies or as independent companies in tax havens³. IBCs are used for a variety of purposes; the principal amongst them is to shift the profitable part of a business to a low tax country. The BVI are world leaders in the formation of IBCs.

The BVI are also the second largest global domicile for investment hedge funds (Sullivan, 2007)⁴. In addition, the BVI have also a strong position in insurance markets, where they tend to specialize in smaller captives (insurance companies). The vast majority of the offshore entities in the BVI (corporations, funds, and so on) are set up in the BVI and are subject to BVI law, but conduct all of their business (and hold all of their assets) elsewhere. In this way, the BVI function as a registration center. Registration centers refer to offshore financial centers that receive foreign money to be re-invested in the country of origin in order to benefit from a preferential tax regime, also known as "round tripping". The Chinese reputedly use BVI for such purposes, since a very large share of foreign investment into China is made by Chinese citizens via the BVI (i.e.: Chinese investors investing in China, but the investment is registered as foreign direct investment since the money comes through the BVI). In fact, the two biggest sources of foreign investment into China in 2007 were Hong Kong and the BVI.

The BVI tax haven has no taxes in place for BVI offshore companies that do not carry out business in the jurisdiction. International business companies therefore pay zero taxes on

² According to Palan et al. (2010), trusts are relationships in which a person or entity (the trustee) holds legal title to certain property (the trust property) but is bound to exercise that legal control for the benefit of one or more individuals or organizations (the beneficiary).

³ A limited liability partnership is a partnership which is a legal entity in its own right. Unlike a general partnership or limited partnership, the partners are not personally liable. Limited liability partnerships are not widely available in offshore jurisdictions but they are certainly available in BVI and Panama (Palan et al., 2010).

⁴ Sullivan (2007) concluded that the big four Caribbean Islands of Cayman, Bermuda, BVI and the Bahamas hosted between them 52.3% of the world's hedge funds in 2006, followed by the US with 30.1%.

the profits, interests, dividends and other types of incomes earned outside of the jurisdiction. BVI offshore corporations pay no corporate tax, capital gains tax, estate tax, withholding tax or income tax. All an offshore company pays in the BVI is an annual fee which is paid to the relevant government authorities. For this reason the BVI can be regarded as a pure offshore tax haven.

In addition, BVI imposes no taxes on offshore bank accounts. This makes the BVI an ideal jurisdiction in which to set up offshore bank accounts.

The development of BVI as a tax haven started in 1984 when the BVI authorities enacted the International Business Companies Act. The International Business Companies Act introduced a new legislation that allowed the formation of offshore companies that were exempt from local taxes. Since then, the BVI have become one of the most important tax havens in the world. In 2000, a report from KPMG to the British government estimated that about 41% of all offshore companies in the world were formed in the BVI (report cited in Palan et al., 2010). On 12 April 2007, the Financial Times reported that the BVI were the world's second largest source of foreign direct investment (behind Hong Kong), with more than US\$123,000,000,000. Almost all of this was directly attributable to investment through the territory's offshore finance industry. This makes the BVI the largest registry of international companies in the world and, thus, they hold an important place in the global financial infrastructure. Like in other tax havens, most of the registered BVI companies undertake all of their financial activities outside of the BVI. Therefore, money and transactions do not flow through the BVI.

In 2004, the International Business Companies Act was replaced by the BVI Business Companies Act. The BVI Business Companies Act differs from the International Business Companies Act in that it refers to both offshore and local companies. Prior to the BVI Business Companies Act, it was possible to incorporate a company under two different statutes: the International Business Companies Act (for offshore companies) and the Companies Act (for local companies).

The main objective of the BVI Business Companies Act was to make the BVI more competitive vis-à-vis other tax havens. In order to accomplish this, it encompasses five features. First, the BVI Business Companies Act considerably eases the requirement for

corporate benefit. Second, it eliminates financial assistance and the concept of share capital with regard to company shares. Both of these eliminate the requirements relating to maintenance of capital and distributable reserves for dividends. Third, it removes restrictions with regard to the declaration of dividends. Fourth, it allows for an extension of the types of companies that can be formed. Under the old International Business Companies Act, it was only possible to form a company limited by shares. Under the new act, it is possible to form a company limited by shares, an unlimited liability company, a company limited by guarantee which can issue shares, a company limited by guarantee which cannot issue shares, a restricted purpose company and a segregated portfolio company⁵. Fifth, the companies are no longer required to have a stated corporate objective, thereby removing a number of difficulties relating to directors' duties.

Apart from incorporating companies, the other area of specialization of the BVI is trusts. The BVI have a special regime for trusts (in addition to the regime for companies, the above referred to IBCs): the Virgin Islands Special Trust Act. The Virgin Islands Special Trust Act makes the BVI jurisdiction very attractive for certain types of trusts as it provides settlors with a level of freedom and protection that was previously either absent from or insufficient in alternative trust laws. For instance, trustees are released from obligations under the English Trust Law (also known as Prudent Man of Business Rule). Amongst other things, this means that trustees are not under the obligation to maximize share value or have management responsibilities.

In addition, the Virgin Islands Special Trust Act can be used for matrimonial settlements, and for corporate and personal succession planning, since it may prevent the forced sale of a company to pay for financial settlements. It can also be used for commercial purposes, because it provides the directors with the ability to make quick decisions, the freedom to diversify (or not) assets and to enter into commercial arrangements.

⁵ In segregated portfolio companies assets and liabilities pertaining to groups of shareholders are effectively parceled in separate cells. Segregated portfolio companies legislation isolates the liabilities to third parties contracting or dealing with a particular cell of the company so that they are attributable to and only enforceable against the assets of that cell. The key point is that a segregated portfolio company is a single corporate structure, which can handle different risks in an isolated way. The advantages of segregated portfolio companies are that shareholders only need to incorporate one company, only have to apply for regulation of one company and only have to file a tax return for one company.

According to the IMF (2010), the BVI's continued ability to attract company registration business relies on being viewed internationally as a well-regulated and policed jurisdiction with a strong legal framework and efficient corporate services. The Financial Services Commission holds the supervisory role. Also in the opinion of the IMF (2010), the Financial Services Commission devotes significant attention to international information sharing and cooperation. For example, the Financial Services Commission has signed the International Organization of Securities Commissions multilateral memorandum of understanding for information sharing.

The Financial Services Commission is an independent supervisory authority with broad powers to regulate the full scope of financial services offered from or in the BVI. The Financial Services Commission Act, which came into effect in 2002, established the Financial Services Commission as an independent statutory body. The Financial Services Commission is allowed to regulate, supervise, and enforce financial services activities carried out in or from the jurisdiction. This includes the right to issue binding guidance, apply terms and conditions to licenses and take a range of enforcement actions. The Financial Services Commission is also responsible for overseeing compliance of companies and limited partnerships with the corporate or partnerships legislation.

Furthermore, the IMF (2010) claims that the Financial Services Commission has demonstrated both its willingness and ability to be a full partner in international information sharing and cooperation. It was for this purpose that the Financial Services International Cooperation Act was repealed in 2006. The Financial Services International Cooperation Act laid down the requirements for information sharing with foreign regulators and foreign law enforcement agencies. Since then, the Act has been amended to incorporate information-sharing provisions that have expanded and clarified the Financial Services Commission's authority. This amendment was carried out in response to concerns raised during discussion of international cooperation initiatives and the process of negotiating to become a signatory to the International Organization of Securities Commissions Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information. The Financial Services Commission has become a full-signatory to this memorandum of understanding.

In spite of this, the BVI are still seen as a very secretive jurisdiction. For instance, the BVI rank 15th in terms of the Financial Secrecy Index (FSI) of the Tax Justice Network (Murphy, 2010)⁶. In fact, while the BVI have the largest number of IBCs registered in any territory, they do not maintain records of those that have discontinued operations. Also, the BVI often permit the migration (known as continuance) of companies (and foundations) in and out of the jurisdictions in a way which onshore jurisdictions do not. Thus, for instance, it is possible for a fully-fledged and operational BVI registered company with BVI directors to become a fully-fledged and operational Jersey registered company with Jersey directors without any break in its legal existence. It is not a merger or a transfer of assets – it is the legal continuance of the same company from one jurisdiction to another.

In addition, BVI have signed a Tax Information Exchange Agreement with a number of industrial countries (The Czech Republic, Germany, Portugal, Ireland, The Netherlands, New Zealand, France, Denmark, Finland, Iceland, Norway, Sweden, The UK, Australia, and The US)⁷. However, the BVI have no double tax treaties with foreign countries which make offshore clients' tax information and financial status safe within the BVI. An added advantage to offshore trading companies incorporated in the BVI is that the jurisdiction has no exchange controls in place, which makes it easy to move funds around.

In spite of the Tax Information Exchange Agreement, the BVI provide exceptional privacy and confidentiality for their offshore clients. In keeping with international banking regulations, offshore banks operating in the offshore jurisdiction of the BVI follow the "know your client" rule. However, they always maintain the privacy and secrecy of the client, and the secrecy is protected by BVI legislation. In fact, according to banking secrecy laws of the BVI, information regarding offshore bank accounts and bank accounts in the jurisdiction can only be disclosed with the consent of the offshore bank account holder or if a court order has been issued handed down. Disclosure of information about an offshore bank account is punishable by BVI law.

⁶ The FSI combines two measurements, one qualitative and one quantitative. The qualitative measure looks at a jurisdiction's laws and regulations, international treaties, and so on, to assess how secretive it is. The second, the quantitative measurement, attaches a weighting to take account of the jurisdiction's size and overall importance to the global financial markets.

⁷ Tax Information Exchange Agreements are bilateral agreements signed to establish exchanges of information for tax purposes.

The BVI as a tax haven also provide confidentiality and privacy to the beneficial owners and directors of offshore business corporations through the BVI's offshore business corporations' act. The names of the offshore company's shareholders, directors and the company's minutes of meetings and resolution documents are not filed with the Registrar of Companies. Information about the beneficial owners is not made public. This means that this information does not become public. Such information is only known to the registered agent of the company who is also responsible for keeping the information. The offshore business legislation provides further privacy by allowing offshore corporations in the BVI to be incorporated using nominee directors and shareholders.

In the offshore tax haven of the BVI an offshore business corporation can be incorporated using just one shareholder and one director. The director can be another BVI corporation. The financial statements and audits of the BVI's offshore corporations are private, and the financial statements are not to be filed with the government authorities in the BVI. The financial statements of offshore companies in the tax haven BVI can be kept at any location convenient to the corporation's members, meaning that no register is required in the BVI.

Summing up, first, the tax haven BVI is specialized in the incorporation of companies and in trusts. Second, the BVI are a tax haven in the traditional sense of the word, since foreign firms are not taxed there. Third, BVI are seen by international organizations as a well regulated financial center. Fourth, in spite of this, there are still in place many legal impediments for the exchange of information with foreign jurisdictions, which in practice makes the BVI an attractive location for tax evasion.

3. Panama

The history of Panama as a tax haven started in 1919 when it began to register foreign ships to help Standard Oil escape US-American taxes and regulations. Offshore finance followed in 1927, when Wall Street interests helped Panama introduce lax company incorporation laws, which let anyone start tax-free, anonymous corporations, with few questions asked. The development of Panama offshore, however, took place in the 1970s. Panama adopted the familiar tax haven model, based on the three pillars of tax havens: the tax exempt company, bank secrecy laws, and competitive incorporation laws, adopting Swiss-style banking

secrecy, abolishing currency controls and setting up tax exempt companies. Financial services are an extremely important sector in Panama. In 2005, financial intermediation contributed about \$1 billion, or 7.2 percent of GDP. Palan et al. (2005) estimate that the large majority of this money is of US origin, making Panama the biggest US-influenced tax haven. In fact, it seems that US corporations and US wealthy individuals tend to prefer Panama to other tax havens, especially for "round tripping" purposes.

Panama has a booming financial services sector which provides services such as the incorporation of International Business Companies, offshore banking, the formation of foundations and trusts, insurance, and the registration of boats and vessels among other services. Panama has 370,000 International Business Companies, third largest number in the world after BVI and Hong-Kong.

The Panamanian financial system is dominated by its banking system, which is the largest in the Central American region with consolidated assets representing more than three times Panama's GDP. A revised banking law and the creation of the Superintendency of Banks in 1998 helped to modernize its regulatory and supervisory framework for banking. This modernization was observed in the IMF's 2007 assessment. In particular, the IMF argues that in the tax haven of Panama there is a high level of observance with the Basel Core Principles for banking supervision.

Panama, like other tax havens, does not impose any taxes on offshore business companies incorporated in Panama even if they do not engage in any business operations in the jurisdiction. However, one of the characteristics of Panama offshore legislation which places the jurisdiction way above other tax havens is that offshore business companies incorporated in Panama are allowed to carry out its business operations both within and outside of Panama's offshore jurisdiction. Panama has income taxes, but because they rely on the territoriality principle to determine the scope of their tax jurisdiction, foreign-sourced income is generally not taxed at all. However, all offshore companies incorporated in Panama are obliged to pay an annual license fee to the government

The tax haven of Panama is able to provide authentic privacy and confidentiality to its offshore clients, in fact this is guaranteed by legislation. The trustees and the agents responsible for setting up a Panama offshore trust must keep all information pertaining to

the trust confidential. Violation of this law can result in imprisonment for up to half a year and monetary fines of up to US\$50,000. There are also confidentiality clauses in place for foundations. All persons involved in the formation of a foundation in Panama (including lawyers, foundation members, agents and bankers) are obliged to keep the foundation information strictly private. Failure to adhere to this will result in criminal penalties.

Panama specializes in offering foundations, that is, a form of trust that is recognized as having separate legal existence akin to a limited company. Foundations are essentially a corporate entity which has legal personality. Usually, a foundation has a board of directors. Unlike a company, a foundation does not have shareholders. A foundation may generally have beneficiaries, charities or non-charitable purposes as its objects, depending upon the jurisdiction. In Panama no approval is needed to create a foundation, and it has a very modern and well drafted foundations law. A Panamanian foundation is formed by a charter and regulations. The charter is a public document but there are limited requirements as to what must be stated in the charter (such as the foundation's name, its objects, winding up provisions and amendment provisions). Details of beneficiaries and the detailed operation of the foundation can instead be stated in the regulations, which are not a public document. Foundations are not widely available in all tax havens.

Panama is also often cited as a jurisdiction that performs money laundering, especially with illegal criminal money. For instance, of the criminal cases identified by the US tax authorities (IRS) investigations from 1978 to 1983 involving illegal income related to drug trafficking, 28% involved Panama (Maingot, 1998). Also Jeffrey (2004) says that "the free trade zone (of Panama) is the black hole through which Panama has become one of the filthiest money laundering sinks in the world". He also believes that terrorists and Colombian drug smugglers use Panama for money laundering.

Panama has banking secrecy laws in place to protect its offshore bank account holders. Panamanian banks are prohibited from disclosing information regarding offshore bank accounts, which is classified as confidential. Information may be given out in cases of criminal investigations, however, if the proper court order has been issued. Failure to comply with these laws can result in fines of up to US\$100,000.

Panama's International Business Companies are also granted privacy in this tax haven. As a tax haven, Panama does not require that the names of the shareholders be registered as public information. To provide added layers of privacy for International Business Companies, Panama permits registration with nominee directors and shareholders in such a way that the names of the beneficial owners do not appear in the registers.

People of any nationality can incorporate in Panama. An offshore corporation needs only three directors, one shareholder and the appointment of a company secretary for incorporation. The tax haven of Panama does not require offshore companies to file annual financial reports with the relevant tax authorities. The fact that offshore companies in the tax haven of Panama have no need to present their records means that this information is kept private to the company.

There are several regulatory agencies involved in the oversight of the financial sector. The regulatory agencies for banking, securities, and insurance sectors, respectively, are the Superintendency of Banks, the National Securities Commission, and the Superintendency of Insurance and Reinsurance. In addition, the Panamanian Autonomous Institute for Cooperatives is responsible for the oversight of cooperative institutions (including credit cooperatives) and the Banco Hipotecario Nacional is responsible for the four savings and credit institutions.

According to the IMF (2007), cross-border arrangements are in place to facilitate information sharing for financial sector regulation, except in the area of insurance. The Superintendency of Banks of Panama has entered into numerous memoranda of understanding with countries where Panamanian financial institutions have affiliates or where Panama is host to foreign-controlled financial institutions. For the securities regulator, memoranda of understandings are also in place with counterparts in Latin America and Spain.

The IMF (2007) says that, in contrast to the banking sector, the regulatory frameworks for the capital markets and insurance sectors remain underdeveloped. The securities law and regulations are generally effective; however, resources for securities markets oversight are insufficient, and a key commissioner position remains unfilled, which affects the overall independence of the National Securities Commission. The Superintendency of Insurance and Reinsurance does not have independence from the industry and the executive branch of

government, and lacks resources for prudential supervision, which will require revision of the underlying legislative framework to be addressed.

In spite of all this, the IMF (2007) believes that in the tax haven of Panama there is a high level of observance of regulatory standards for the systemically relevant banking sector. In comparison, however, the other two key financial sectors—securities markets and insurance—have a lower level of compliance with the respective regulatory standards. In addition, the supervisory and regulatory arrangements for cooperative credit institutions and savings and credit institutions are underdeveloped.

Not everyone, though, agrees with the assessment made by IMF (Shaxson, 2011). The fact is that Panama is yet to sign any tax treaties with foreign countries. In addition, Panama has no information exchange provisions. This is to the advantage of offshore clients. Another advantage that tax haven Panama represents is the fact that its government has passed no exchange control laws. This makes it easy for offshore companies to move funds, since there are no questions to be answered or forms to be filled in. Therefore, Panamanian offshore companies are free to engage in international trade. The offshore tax haven of Panama gives clients a medium to reduce tax liabilities and still provides them with excellent asset protection.

Summing up, first, the tax haven Panama is specialized in the incorporation of companies and formation of foundations. Second, Panama is a tax haven in the traditional sense of the word, since foreign firms are not taxed there. Third, the tax haven of Panama is seen by international organizations as a relatively well regulated financial center. Fourth, in spite of this, there are still in place many legal impediments for the exchange of information with foreign jurisdictions, which in practice make Panama an attractive location for tax evasion as well as for illegal money from criminal activities.

4. Discussion

In this note, we have looked to the history and the main characteristics of the tax havens The British Virgin Islands (BVI) and Panama. We have discussed the financial channels used in these jurisdictions to move money and assets across borders, such as the incorporation of corporations, known as International Business Corporations. We have argued that these jurisdictions need to do much more in the respect to increase the transparency in

international capital transactions, to fight tax evasion and tax fraud, and to cooperate with tax authorities in foreign countries.

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